



Memorandum # 41/2002

Commonwealth of Massachusetts | Public Employee Retirement Administration Commission

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Joseph E. Connarton, *Executive Director*

MEMORANDUM

TO: All Retirement Boards

FROM: Joseph E. Connarton, Executive Director

RE: Hedge Fund Investment Guidelines

DATE: October 25, 2002

At its October 16 meeting, the Commission approved the issuance of guidelines that will govern and regulate investment in various hedge fund strategies for Massachusetts local public retirement systems.

Issuance of these guidelines does not mean that PERAC endorses the use of hedge funds in retirement board portfolios or considers them an essential component of asset allocation. The Commission heard impassioned arguments on both sides of the question as to whether hedge funds were appropriate investments for Massachusetts' retirement boards. In the end, it decided that boards that qualify under the guidelines should not be denied the opportunity to consider diversifying their portfolios with investments that are intended to have very low correlation to the traditional major market indexes.

The guidelines describe a regulatory process that goes beyond that required for other asset classes by existing PERAC regulations. These additional steps are intended to ensure that any retirement boards that meet the minimum standards for investment in hedge funds and decide to pursue investments in this area do not do so lightly but with a seriousness and commitment that reflects an understanding of the unique risks in this area. Besides having a basic understanding of the often complex investment strategies involved, boards must have a compelling rationale for the role that hedge funds will play in their portfolio and specific plans as to how such investments will be structured in terms of strategy and product types. In conducting searches for hedge funds, boards must be committed to work with their investment consultant to perform a due diligence far more challenging and intensive than that required for managers in traditional asset classes.

Similarly, PERAC will not be taking its responsibilities lightly in this area. It will deny authorization to any board that fails to communicate a well-conceived, prudently structured strategy for investing in hedge funds. The Commission will refuse to issue regulatory approval for managers it deems to have clearly insufficient or questionable credentials or who fail to meet reasonable standards of experience and capability. The Commission will also deny an application if the process used to select the manager appears flawed or where financial arrangements raise questions regarding the selection process. The Commission may cite these and other reasons as justification to deny authorization.

Any questions concerning the guidelines should be addressed to Robert Dennis, Investment Director, at 617-666-4446 ext 922.